

DO-IT-YOURSELF RETIREMENT: ALLOWING EMPLOYEES TO DIRECT THE INVESTMENT OF THEIR RETIREMENT SAVINGS

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Workers are increasingly encouraged to select the investments in which their retirement savings will be placed. Many in Congress and the Executive Branch advocate the creation of personal accounts in Social Security. As with many retirement plans, workers would be allowed to choose the investment for the amounts allocated to them, although the range of choices may be fairly narrow. The consequences of workers' investment choices will affect society and their employers as well as the individuals. The existing evidence raises questions about whether the individuals are well-suited to handle investment of their retirement savings when confronted with too many choices or too little understanding of markets.

I. INTRODUCTION

Americans pride themselves on being self-sufficient. From home improvement to health savings accounts, Americans are evidencing a preference for handling themselves matters that were previously managed by professionals. This is particularly evident in the area of retirement investing.

In the past, retirement investing was typically handled by professional investment managers. However, there has been an increasing trend towards allowing (and even encouraging) participants to direct the investment of their retirement plan accounts. The primary federal statute governing retirement plans, the Employee Retirement Security Act of 1974

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(ERISA),¹ does not require (as many plans do not) notifying participants² that they have the option not to direct the investment of their accounts. Additionally, the President and many in Congress propose to allow individuals to direct the investment of a portion of the amounts that will provide for their Social Security benefits.

This Article examines the effect on individuals and employers of allowing workers to direct their own investment. The second Part of this Article discusses the manner in which individuals may be able to direct the investment of their retirement savings through employer-provided retirement plans as well as under the personal accounts proposals to reform the Social Security system. The third Part analyzes the ability of participants to successfully direct the investment of their accounts. In the fourth Part, the Article addresses the ramifications for employers when allowing participants to handle the investment of their accounts. Finally, the fifth Part provides suggestions for improving our retirement system.

II. RETIREMENT BENEFITS

Typically, retirement savings are comprised of retirement plan benefits, Social Security benefits, and personal savings and investments. These are often referred to as the “three-legged stool” of retirement planning, with the idea that all three of these factors are needed for a stable income in retirement.³ This Part addresses two of the three factors: employer-provided retirement plans and Social Security.

1. 29 U.S.C. §§ 1001–1461 (2002). This Article focuses on the fiduciary provisions contained in ERISA. However, ERISA also imposes certain requirements with respect to most employer-provided retirement plans in areas that include coverage, disclosures, participation, vesting, and funding. 29 U.S.C. §§ 1021–1086. It also regulates litigation related to ERISA. 29 U.S.C. §§ 1109, 1113, 1132. Additionally, it addresses plan termination. 29 U.S.C. §§ 1301–1371.

2. The term “participant” is used in this Article to refer to both participants and beneficiaries, as this Article primarily involves ERISA’s fiduciary requirements, which refer to both participants and beneficiaries. 29 U.S.C. § 1104. ERISA defines the term “participant” as:

any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.

29 U.S.C. § 1002(7). ERISA defines the term “beneficiary” as “a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder.” 29 U.S.C. § 1002(8).

3. Social Security Online, Agency History, Research Note #1: Origins of the Three-Legged Stool Metaphor for Social Security (May 1996), <http://www.ssa.gov/history/stool.html>.

A. Employer-Provided Retirement Plans

Employers typically use retirement plans as a means of obtaining and retaining employees. The manner in which retirement plan benefits have been provided has changed significantly over the past twenty-five years.

1. Defined Benefit Plans

Historically, retirement benefits were provided through defined benefit plans.⁴ Participants in defined benefit plans typically accrue benefits based on their years of service with the employer and average compensation. These plans are generally funded through employer contributions and earnings on the plans' investments.

Defined benefit plans are required to meet certain minimum funding requirements in order to ensure that the trust will have sufficient assets to provide the level of benefits described in the plan document.⁵ The minimum funding level is based on a funding method that includes reasonable assumptions about the length of time the participants are expected to live and the anticipated rate of return for the plan's assets.⁶ Other factors such as employee turnover and anticipated salary increases may also be taken into consideration. Employers are required to make annual contributions to satisfy these minimum funding requirements.⁷

Earnings can have a significant role in determining the amount an employer must contribute to a defined benefit plan in order to satisfy the minimum funding requirements. For example, during the bull market of the 1990s, many employers did not need to make any contributions to their defined benefit plans.⁸ However, as stock market returns have declined over the past few years, employers have needed to make significant contributions to their defined benefit plans in order to meet the minimum funding requirements for these plans.

4. See PBGC, Pub. No. 1007, *A Predictable, Secure Pension for Life: Defined Benefit Plans* (Jan. 2000), available at http://www.pbgc.gov/docs/A_Predictable_Secure_Pension_for_Life.pdf (explaining that nearly all of the early pension plans were defined benefit plans).

5. See 26 U.S.C. § 412 (2000); 29 U.S.C. § 1082 (2000) (referring to minimum funding standards).

6. 29 U.S.C. § 1082 (2000).

7. *Id.*

8. Roger M. Kubarych, *The Next Big US Policy Issue*, Council on Foreign Relations July 24, 2003, available at http://www.cfr.org/pub6143/roger_m_kubarych/the_next_big_us_policy_issue.php.

2. Defined Contribution Plans

Today, many employers are choosing to offer retirement benefits through defined contribution plans. The retirement benefits provided to a participant through a defined contribution plan are equal to the value of the contributions, forfeitures, and investment earnings and losses allocated to the participant's account.⁹ Many defined contribution plans allow employees to elect to defer a portion of their compensation to the plan, known as an elective deferral. Unlike with defined benefit plans, employers are not required to make contributions to defined contribution plans.¹⁰ However, contributions to such plans are typically made by both employees and employers.

The risk of investment loss is borne by participants. Investment returns directly affect the retirement benefits received by participants.¹¹ However, the earnings for a defined contribution plan's investments usually have no effect on the amount the employer chooses to contribute to the plan. There is no minimum funding requirement for a defined contribution plan, unless the plan requires employer contributions.

The number of defined contribution plans has increased significantly over the last twenty-five years. From 1980 to 2000, defined contributions plans have nearly doubled to 687,000 plans, while private-sector defined benefit plans declined by nearly two-thirds to 48,000 plans.¹²

Additionally, the number of defined contribution plans that allow participants to make elective deferrals, known as 401(k) plans, has increased substantially. An examination by the U.S. Department of Labor (DOL) of the 1999 Annual Return/Reports of Employee Benefit Plans revealed that 401(k) plans covered over 70% of all pension-covered participants.¹³ The study reflected that in 1999, 60% of all contributions to defined contribution plans were made by employees.¹⁴ The assets held in

9. 29 U.S.C. § 1082 (2000).

10. 26 C.F.R. § 1.401-1(b)(2) (1976).

11. This assumes that the investment loss did not result from a breach of fiduciary duty. *See generally* 29 U.S.C. § 1104 (2002) (describing fiduciary duties and standard with respect to an Employee Retirement Income Security Act).

12. EMPLOYEE BENEFITS SECURITY ADMIN., U.S. DEP'T OF LABOR, PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 1999 FORM 5500 ANNUAL REPORTS 75 (2004), <http://www.dol.gov/ebsa/PDF/1999pensionplanbulletin.pdf> (indicating that from 1980 to 1999, the number of defined contribution plans increased from 340,805 to 683,100 plans, while the number of defined benefit plans decreased from 148,096 to 49,895 plans); *see also* EMPLOYEE BENEFITS SECURITY ADMIN., U.S. DEP'T OF LABOR, PRELIMINARY PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 2000 FORM 5500 ANNUAL REPORTS 75 (2005).

13. PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 1999 FORM 5500 ANNUAL REPORTS, *supra* note 12, at 4.

14. *Id.* at 3.

401(k) plans have increased by approximately 13% per year since 1990.¹⁵ By the end of 2004, there were approximately \$2.1 trillion held in 401(k) plans.¹⁶

3. Responsibility for Plans' Investments

The fiduciaries of both defined benefit and defined contribution plans are responsible for managing the plans' investments.¹⁷ ERISA section 404(a) provides that the fiduciaries for employee benefit plans are required to discharge their duties regarding the plan: (i) solely in the interest of participants; (ii) for the exclusive purpose of providing benefits to participants and paying reasonable administrative expenses; (iii) using the "care, skill, prudence and diligence" that a prudent person would use; (iv) by diversifying the plan's investments; (v) in accordance with the plan's documents unless they conflict with ERISA.¹⁸ These standards are among "the highest known to the law."¹⁹

In handling a plan's investments, fiduciaries are required to engage in a prudent process. ERISA section 404(a)'s requirements will be satisfied if the fiduciary has given appropriate consideration to the relevant facts and circumstances regarding a particular investment or investment course of action and has acted accordingly.²⁰ In *Riley v. Murdock*, the court explained:

Courts have articulated two way[s] in which to measure a fiduciary's use of prudence in carrying out their duties. The first is whether the fiduciary employed the appropriate methods to diligently investigate the transaction and the second is whether the decision ultimately made was reasonable based on the information resulting from the investigation.²¹

Courts have indicated that they will focus on whether the fiduciaries engaged in a prudent process as opposed to the outcome of their

15. Investment Company Institute, *Frequently Asked Questions About 401(k) Plans*, Sept. 2005, http://www.ici.org/home/faqs_401k.html.

16. *Id.* See also Eric Hazard, *SPARK: 401(k) Assets Up 22% in '03*, Apr. 19, 2004, http://www.plansponsor.com/pi_type10/?RECORD_ID=25083 (reporting that the Management Report from the Society of Professional Administrators and Recordkeepers (SPARK) shows that the assets in 401(k) plans reached \$1.795 trillion in 2003).

17. 29 U.S.C. §1104(a) (2002).

18. *Id.*

19. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 284 F. Supp. 2d 511, 549 (S.D. Tex. 2003) (quoting *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982); *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 294 (5th Cir. 2000)).

20. 29 CFR § 2550.404a-1(b)(1) (1977).

21. *Riley v. Murdock*, 890 F.Supp. 444, 458 (E.D.N.C. 1995) (citation omitted).

decisions.²²

The courts have made it clear that good intentions are not enough. The court in *Donovan v. Cunningham* bluntly stated that fiduciaries may not escape the reasonable man/ reasonable person standard of prudence in making investments by having “a pure heart and an empty head.”²³

Fiduciaries can shift the responsibility for investing the assets in a defined contribution plan. ERISA section 404(c) provides protection for fiduciaries from losses that result from participants’ exercise of control over the investment of their retirement plan accounts if certain requirements are met.

The regulation to ERISA section 404(c) enumerates the requirements for fiduciaries to be afforded 404(c) protection, which can generally be divided into four broad categories. These include: (i) affording participants certain opportunities; (ii) satisfying disclosure requirements; (iii) offering certain categories of investments; and (iv) refraining from prohibited activities.²⁴

In order to satisfy ERISA section 404(c), participants must be afforded the opportunity to exercise control over assets in their accounts. In order for participants to be given this opportunity, the plan must provide that the participant has a reasonable opportunity to give investment instructions to an identified plan fiduciary or an agent of the fiduciary.²⁵ Additionally, participants must be able to obtain written confirmation of their investment instructions.²⁶

Participants must be given sufficient information to make informed decisions regarding the plan’s investments, including an explanation that the plan intends to comply with ERISA section 404(c) and that the fiduciaries may be relieved of liability for losses resulting from the participant’s investment instructions.²⁷ Furthermore, participants must be given descriptions of: (i) the investment options offered by the plan; (ii) the investment objectives; (iii) the “risk and return characteristics” for each investment option; (iv) “any designated investment managers”; (v) the circumstances under which they can give investment instructions, including any limitations; (vi) “voting, tender and similar rights,” including any

22. *Laborers Nat’l Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313 (5th Cir. 1999), *cert. denied sub nom. Laborers Nat’l Pension Fund v. Am. Nat’l Bank & Trust Co.*, 528 U.S. 967 (1999); *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983); *Springate v. Weighmasters Murphy, Inc. Money Purchase Pension Plan*, 217 F. Supp. 2d 1007, 1023 (C.D. Cal. 2002); *Bevel v. Higginbottom*, No. CN-98-474-X, 2001 WL 1352896 (E.D. Okla. Oct. 4, 2001).

23. *Donovan*, 716 F.2d at 1467.

24. 29 U.S.C. § 1104 (2002).

25. 29 C.F.R. § 2550.404c-1(b)(2) (1992).

26. *Id.*

27. *Id.*

restrictions; (vii) any transaction fees and expenses which affect their account balances; and (viii) the additional information available upon request as well as the contact information for the plan fiduciary responsible for providing that information.²⁸ The plan must also provide “a copy of the most recent prospectus provided to the plan” if participants invest in an option that is subject to the Securities Act of 1933, such as a mutual fund.²⁹ Additional requirements apply for employer securities.³⁰

Participants must be given the option of choosing from a broad range of investment alternatives.³¹ A range of investment options is considered to be broad if participants are reasonably able to materially affect the risk and return of their accounts. Participants must be given at least three designated investment options, which in the aggregate enable them to: (i) create a portfolio with risk and return characteristics that would be appropriate for a participant; (ii) diversify their accounts so as to minimize the risk of large losses; and (iii) change their investment allocation at least once every three months.³² Each of the three investment options must: (i) be diversified; (ii) have “materially different risk and return characteristics”; and (iii) when combined with other investments offered, tend to minimize the risk of the participant’s portfolio.³³ Additional requirements apply if participants can invest in certain options more frequently than they can invest in the designated options.³⁴

In order for plans to satisfy ERISA section 404(c), their fiduciaries and plan sponsors must refrain from certain actions. Fiduciaries and plan sponsors may not subject participants to improper influence.³⁵ Fiduciaries may not conceal material non-public facts regarding plan investments, unless revealing such facts would violate federal or state law that is not preempted by ERISA.³⁶ Additionally, transactions involving a fiduciary must be fair and reasonable to the participant.³⁷

Although the regulation to ERISA section 404(c) describes the requirements for an “ERISA section 404(c) plan,” its provisions appear to apply on a transaction-level basis.³⁸ For example, a plan that fails to deliver a prospectus to one participant for one investment option would technically fail to satisfy ERISA section 404(c) for that particular

28. *Id.*

29. *Id.*

30. *Id.*

31. 29 C.F.R. § 2550.404c-1(b)(1) (1992).

32. 29 C.F.R. § 2550.404c-1(b)(3).

33. *Id.*

34. 29 C.F.R. § 2550.404c-1(b)(2)(C).

35. 29 C.F.R. § 2550.404c-1(c)(2).

36. *Id.*

37. 29 C.F.R. § 2550.404c-1(c)(3).

38. 29 C.F.R. § 2550.404c-1(d)(2).

transaction. However, courts have yet to opine on whether every single requirement must be satisfied in order for fiduciaries to rely on the protection afforded by ERISA section 404(c).

Many 401(k) plans allow participants to direct the investment of their 401(k) accounts. One study revealed that 87% of 401(k) plan participants direct the investment of all or part of their accounts.³⁹ A study conducted in 2004 reflected that 93% of plan sponsors surveyed make a statement that the plan intends to comply with ERISA section 404(c).⁴⁰

B. *Proposed Personal Accounts in Social Security*

If employer-sponsored retirement plans are the first leg of the three-legged stool, then Social Security is the second leg. With the passage of the Social Security Act,⁴¹ a social insurance program was created to pay retired workers continuing income after disability or retirement.

1. Historical Approach

Since 1940, benefits have been paid as a monthly amount for the life of the individual.⁴² Retirement benefits are based in part on the worker's average compensation. Benefits are primarily funded through explicit payroll taxes that are not intended to be used for any other purpose.⁴³ Payroll taxes for Social Security's retirement and disability insurance benefits (Old-Age, Survivors, and Disability Insurance, hereinafter OASDI) are equal to 12.4% of each worker's compensation, up to \$90,000 per year, for 2005.⁴⁴ The benefits that current Social Security retirees receive are paid out of taxes collected from today's workers.⁴⁵ Any money left over from the payroll taxes withheld is credited to the Old-Age and Survivors Insurance (OASI) trust fund.⁴⁶

The trust fund is invested in special issue Treasury bonds and

39. PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 1999 FORM 5500 ANNUAL REPORTS, *supra* note 12, at 3.

40. DELOITTE CONSULTING LLP, DELOITTE CONSULTING 2004 ANNUAL 401(K) BENCHMARKING SURVEY, Apr. 2005, http://www.deloitte.com/dtt/cda/doc/content/Annual_401k_Benchmarking_Survey_2004%281%29.pdf.

41. 42 U.S.C. §§ 401–434 (2003).

42. Social Security Administration Home Page, Historical Development at 4 (1997), <http://www.ssa.gov/history/pdf/histdev.pdf>.

43. 26 U.S.C. § 3101 (2000); The Heritage Foundation, *Social Security Basics*, Web Memo #143 (Sept. 12, 2002), <http://www.heritage.org/Research/SocialSecurity/wml143.cfm>.

44. Office of the Commissioner; Cost-of-Living Increase and Other Determinations for 2005, 69 Fed. Reg. 62,497, 62,499 (Oct. 26, 2004).

45. *Social Security Basics*, *supra* note 43.

46. *Id.*

certificates of indebtedness.⁴⁷ The Treasury bonds can only be issued to and redeemed by the trust fund.⁴⁸ The bonds pay the same interest as regular Treasury bonds issued on the same day and in the same maturity.⁴⁹ However, when they mature the bonds are rolled over into new bonds, which include both the original issue amount and the interest due.⁵⁰ Analysts of Social Security have concluded that the trust funds “are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures.”⁵¹

The Century Foundation has undertaken an analysis of the anticipated benefits received by workers with the taxes paid by such workers that reflects one of the major criticisms of the current system. Using these amounts, the Foundation calculated an estimated rate of return on workers’ “contributions” to the Social Security program. They found that a couple with one worker who earned an average income would receive a real rate of return of 3.75% upon turning age sixty-five in 2029.⁵² A single man with low earnings who is sixty-five in 2029 can expect to have an average rate of return of around 2.4%.⁵³ However, a single male with high earnings would lose money, with a rate of return of -0.72%.⁵⁴

The Century Foundation’s position and similar criticism are rejected by opponents of personal accounts, who argue that it is important to recognize that the Social Security system is a social insurance program, rather than an investment vehicle. According to President Franklin D. Roosevelt, who helped found Social Security, the Social Security program was intended to reduce poverty among the elderly.⁵⁵ Supporters assert that

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT OF THE U.S., *Analytical Perspectives*, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2000 337 (1999).

52. SOCIAL SECURITY REFORM: A CENTURY FOUNDATION GUIDE TO THE ISSUES 22 (Century Foundation Press, 2002 ed.).

53. *Id.*

54. *Id.*

55. The American Institute of Public Accountants Home Page, *Understanding Social Security Reform: The Issues and Alternatives*, at 14–15, Mar. 2005, http://www.aicpa.org/download/members/socsec/SOCIAL_SECURITY_REFORM_3-2005.pdf; Social Security Administration Home Page, Presidential Statements, Franklin D. Roosevelt, FDR’s Statements on Social Security. Radio Address on the Third Anniversary of the Social Security Act, Aug. 15, 1938, <http://www.ssa.gov/history/fdrstmts.html#radio>). President Roosevelt is quoted as stating:

The Social Security Act offers to all our citizens a workable and working method of meeting urgent present needs and of forestalling future need. It utilizes the familiar machinery of our Federal-State government to promote the

this has been a major accomplishment of the Social Security system, with poverty 35.2% lower in 2000 than it was in 1959.⁵⁶ It is estimated that the poverty rate among the elderly would be 48% if the Social Security system did not exist and changes had not been made to the economy or other government programs.⁵⁷ Social Security payments comprise more than 90% of the income of 30% of its recipients and more than 50% of the income for almost 60% of recipients.⁵⁸

2. Personal Accounts Proposal

In December 2001, the President's Commission to Strengthen Social Security ("Commission") recommended that Social Security be revised to allow for voluntary personal accounts placed in private investments.⁵⁹ All three of the alternative models for Social Security reform developed by the Commission included voluntary personal accounts.⁶⁰ Under each of the three models, workers could voluntarily invest a percentage of their wages in a personal account.⁶¹

President George W. Bush supports the concept of voluntary personal accounts as recommended by the Commission. In his 2005 State of the Union Address, the President proposed voluntary contributions to personal accounts.⁶² He recommended that contribution limits be increased over

common welfare and the economic stability of the Nation.

The Act does not offer anyone, either individually or collectively, an easy life—nor was it ever intended so to do. None of the sums of money paid out to individuals in assistance or in insurance will spell anything approaching abundance. But they will furnish that minimum necessity to keep a foothold; and that is the kind of protection Americans want.

Id.

56. *Id.*

57. *Id.*

58. *Id.*

59. THE PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC., STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS 13–16 (Dec. 21, 2001), available at http://www.csss.gov/reports/Final_report.pdf. For background information on the origins of personal accounts, see Jeffrey H. Birnbaum, *Private-Account Concept Grew From Obscure Roots*, WASH. POST, Feb. 22, 2005, at A1.

60. THE PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC., *supra* note 59, at 14–16.

61. *Id.* Under Model 1, workers could invest up to 2% of their wages. *Id.* at 14. Model 2 provides for an investment of up to 4% (up to \$1,000 per year, indexed annually to wage growth). *Id.* at 15. Model 3 creates personal accounts through "a match of part of the payroll tax—2.5% up to \$1000 annually (indexed annually for wage growth)—for any worker who contributes an additional 1 percent of wages subject to Social Security payroll taxes." *Id.* at 16.

62. President George W. Bush, State of the Union Address (Feb. 2, 2005), available at <http://www.whitehouse.gov/news/releases/2005/02/20050202-11.html>.

time, to up to 4% of workers' payroll taxes.⁶³ There would be a cap on contributions of \$1000 per year in 2009, which would increase by \$100 per year plus growth in average wages.⁶⁴ The President has recommended that workers have the ability to choose from several low-cost, broad-based investment funds.⁶⁵ Workers would be able to change their investment allocations periodically.⁶⁶

President Bush proposes that the investment options would be similar to the federal employee retirement program, known as the Thrift Savings Plan (TSP).⁶⁷ The investment options would be held in pooled accounts and would be managed by private investment managers, where the selection of the investment managers would be done through a competitive bidding process.⁶⁸ Workers' accounts would be invested in a combination of conservative bonds and stock funds.⁶⁹

Workers would be able to invest their accounts in a small number of very broadly diversified index funds patterned after the current TSP funds . . . [including] a safe government securities fund; an investment-grade corporate bond index fund; a small-cap stock index fund; a large-cap stock index fund . . . an international stock index fund . . . [and] a government bond fund with a guaranteed rate of return above inflation. Workers would also have the option of choosing a "life cycle portfolio," which would decrease the level of investment risk of the workers' accounts as they aged.⁷⁰

Regardless of the options selected, workers' investment choices would be automatically adjusted as they neared retirement age.⁷¹ Unless the worker and his or her spouse specifically opted out, the account would be automatically invested in a life cycle portfolio when the worker reached age 47.⁷² The life cycle portfolio would gradually shift the allocation of investments towards secure bonds as the individual nears retirement.⁷³

Although the investment options initially proposed by President Bush are limited and professionally managed, some have expressed concerns about the ability of personal accounts to provide adequate retirement savings. For example, Yale University economist Robert J. Shiller

63. *Id.*

64. THE PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC., *supra* note 59, at 15.

65. Bush, *supra* note 62.

66. THE PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC., *supra* note 59, at 6.

67. Bush, *supra* note 62.

68. THE PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC., *supra* note 59, at 6.

69. *Id.*

70. *Id.* at 7.

71. *Id.*

72. *Id.*

73. *Id.*

suggests that under the President's proposal, the use of life cycle accounts would result in workers receiving less in benefits when they use personal accounts, instead of receiving traditional benefits under the Social Security system.⁷⁴

The President's proposal also considers allowing workers to select from a broader range of investment options after the initial accounts reach \$5000.⁷⁵ After reaching the threshold limit, the accounts could be invested in a range of private-sector funds.⁷⁶ These investment options would be limited to funds that are "very diversified and reflect the performance of many companies spanning all major commercial sectors."⁷⁷ Funds could only impose one fee per year, expressed as a percentage of assets.⁷⁸

The report of the President's Commission to Strengthen Social Security indicates that money invested in personal accounts reduces the amount that will be needed for future Social Security payments:

[E]very dollar invested in a personal account reduces the cost of future Social Security payments by one dollar, plus the offset rate of interest that is proposed for each plan (ranging from 2 percent to 3.5 percent after inflation). Total expected benefits to the worker are increased by the compounded difference between the offset rate of interest for the Reform Model and the expected rate of return earned by the personal account. So long as the personal account earns a return higher than the offset rate, both Social Security and the individual come out ahead.⁷⁹

Both the Social Security system and workers will be in a better position if personal accounts earn higher rates of return than the offset rate. However, workers are likely to receive lesser Social Security benefits in the event that the rates of return for their accounts do not exceed the offset rate.

74. Robert J. Shiller, *The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation* 2, March 2005, <http://www.irrationalexuberance.com/ShillerSocSec.doc>. Shiller found that "[u]sing historical returns, the life-cycle portfolio loses money 32% of the time (i.e., 32% of the time the internal rate of return is less than the 3% real return required to break even in the proposal)." *Id.* at 3. Shiller found the median rate of return to be 3.4% annually. The study also found that the life-cycle portfolio loses money 71% of the time when "more realistic adjusted returns" are used, with a median rate of return of 2.6% annually. *Id.* David C. John, a Social Security Analyst with the Heritage Foundation, indicated that Shiller's "more realistic adjusted returns" are not supported by other studies. Jonathan Weisman, *Retirement Accounts Questioned: Paper Challenges Expected Benefits*, WASH. POST, Mar. 19, 2005, at E1. Goldman Sachs economists also indicated that returns may be lower than the 3% offset, and Jeremy J. Siegel, a finance professor at the University of Pennsylvania's Wharton School stated, "You can't get three percent in the market anymore." *Id.*

75. Assoc. Press, *Bush Advisers OK Social Security Plan*, N.Y. TIMES, Jan. 28, 2005.

76. THE PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC., *supra* note 59, at 46.

77. *Id.*

78. *Id.*

79. *Id.* at 74.

Thus, the balance between affording significant personal choice and restricting choice sufficiently to make higher returns more likely will consume much of the debate over personal accounts in the future.

III. EFFECTIVENESS OF PARTICIPANT-DIRECTED INVESTMENT OF 401(k) ACCOUNTS

A. *Ability of Participants to Properly Invest Their Accounts*

Many retirement experts have expressed the opinion that most participants are not properly directing the investment of their retirement accounts. Zvi Bodie of the Pension Research Council has stated that “[l]ike surgery, asset allocation is a complex procedure, requiring much knowledge and years of training. No one would imagine that patients could perform surgery to remove their own appendices after reading an explanation in a brochure published by a surgical equipment company.”⁸⁰ Experts cite a variety of reasons why participants are not adequately allocating their accounts, including inadequate diversification and over-investment in company stock. Additionally, they note problems with the investment options offered to participants as well as the manner in which they are offered. However, there are conflicting results regarding the effect on participants’ rates of return.

1. Concerns Regarding Participants’ Investment Selections

Numerous studies indicate that many participants are not adequately prepared to manage the investment of their retirement accounts. A 2004 survey by the Vanguard Center for Retirement Research indicated that although most “retirement investors” had given some thought to investing for retirement, many did not have specific plans.⁸¹ For example, the research revealed that “[o]nly 41% [had] a target goal for asset accumulation.”⁸² The survey also reflected that 28% of the investors who participated in the survey had given little or no thought to the risk of investing in stocks in retirement.⁸³ The 2003 National Survey of Employers and Employees found that fewer than 30% of employees surveyed were “confident in their ability to make the right financial

80. Zvi Bodie, *An Analysis of Investment Advice to Retirement Plan Participants*, 10 (Pension Research Council, Working Paper No. 2002-15, 2002), available at <http://prc.wharton.upenn.edu/prc/PRC/WP/WP2002-15.pdf>.

81. JOHN AMERIKS ET AL., THE VANGUARD GROUP, EXPECTATIONS FOR RETIREMENT: A SURVEY OF RETIREMENT INVESTORS 1 (2004), https://institutional4.vanguard.com/iip/pdf/CRR_RetirementExpectations.pdf.

82. *Id.*

83. *Id.* at 5.

decisions for themselves and their families.”⁸⁴

Additionally, the manner in which many participants invest their retirement accounts appears to be questionable. According to the JPMorgan Retirement Plan Services 401(k) Quiz, 96% of participants could not put investments in order from the most conservative to the most aggressive.⁸⁵ The quiz also found that only 38% correctly identified the penalty for early withdrawals and only 47% were aware that they needed to reallocate their assets as a result of changes in their investment goals or time horizon.⁸⁶ Other surveys have found that many participants fail to diversify their accounts and, instead, hold only one or two investments in their 401(k) accounts.⁸⁷ Data also indicate that many participants over-invest in company stock.⁸⁸ As discussed below, research has also indicated that participants’ opinions about the stock market are not supported by historical data; participants tend to follow the path of least resistance and experience information overload.

Research has found that participants’ perceptions of the stock market are often unrealistically based on historical data. Participants predicted a 63% chance that the stock market would decrease by 10% in the upcoming year, while the historical risk of this happening is only 14%.⁸⁹ They believed that there was a 51% chance that the stock market might drop by one-third in a given year, although the historical risk is only 2%.⁹⁰ They also estimated “a 37% chance that stocks might earn 20% per year for the coming decade,”⁹¹ although the chance of this happening was only 1%.⁹²

84. METLIFE, THE METLIFE STUDY OF EMPLOYEE BENEFITS TRENDS: FINDINGS FROM THE 2003 NATIONAL SURVEY OF EMPLOYERS AND EMPLOYEES 9 (2003), <http://www.metlife.com/WPSAssets/21038406741080074055V1Femployee%20benefit%20trends.pdf>.

85. Kip McDaniel, *401(k) Participants Fail Retirement Quiz*, Apr. 4, 2005, http://www.plansponsor.com/pi_type10_print.jsp?RECORD_ID=28921.

86. *Id.*

87. William J. Arnone, *Educating Pension Plan Participants* 10 (Pension Research Council, Working Paper No. 2004-7, 2004), available at <http://rider.wharton.upenn.edu/~prc/PRC/WP/WP2004-7.pdf> (“Fidelity Investments (2003) found in one survey that a quarter of DC plan participants held only a single investment asset in their 401(k) plans; and Hewitt Associates (2002) notes that 41 percent of plan participants held only one or two funds in 2002.”).

88. *Id.* at 11 (“Other data show that more than 8 million 401(k) participants held more than 20 percent of their plan assets in company stock. Overall, company stock still dominates many pension plan accounts, averaging 42 percent of balances among participants holding *any* company stock.”) (citation omitted).

89. JOHN AMERIKS ET AL., *supra* note 81, at 14 (estimating the historical risk over the 1926–2003 period).

90. *Id.*

91. *Id.*

92. *Id.* (indicating that the chance of an annual 20% gain over any year in a rolling ten-year period from 1926–2003 is only 1%).

Julie Agnew and Lisa R. Szykman of the Center for Retirement Research at Boston College found in their research “that individuals are not making choices that best fit their needs.”⁹³ They indicate that there is strong evidence suggesting that participants often make choices based on the “path of least resistance.”⁹⁴ Their report indicates that “[l]iterature suggests that procrastination, the status quo bias, and anticipated regret are all reasons for individuals’ tendency to follow the path of least resistance.”⁹⁵ They found that many participants utilize the plans’ default options as a result.⁹⁶ They stated that “[a]ccepting the default options defeats the purpose of a self-directed investment account and, depending on the default options, can have an adverse affect on the participant’s savings.”⁹⁷

Agnew and Szykman also studied the effects of information overload on participants.⁹⁸ They found that “[r]esearch in the decision-making literature suggests that rather than processing more information when decisions become more complex, consumers tend to reduce the amount of effort they expend in order to make their decision or choice.”⁹⁹ They indicated that 80% of participants in plans that had automatic enrollment were invested in the plan’s conservative default investment fund and over 50% of these participants remained in the default fund three years later.¹⁰⁰

Agnew and Szykman indicated that they did not consider the default investment to be a particularly good choice for participants as this option is “not generally optimized for the individual.”¹⁰¹ They stated that “investment in the default options often results in inadequate savings for many individuals” as these tend to be conservative investment options.¹⁰² They also indicated that the use of the default “suggests that individuals are not carefully considering their options, which may have an adverse effect on one’s future financial security.”¹⁰³

Agnew and Szykman found that participants’ investment knowledge

93. Julie Agnew & Lisa R. Szykman, *Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice and Investor Experience 3* (Ctr. for Ret. Research, Working Paper No. 2004-15, 2004), available at http://www.bc.edu/centers/crr/papers/wp_2004-15.pdf (citation omitted).

94. *Id.* (citation omitted).

95. *Id.* (citation omitted).

96. *Id.*

97. *Id.* (citation omitted).

98. See *id.* at 4 (reasoning that people are reluctant in making decisions about investments within their defined contribution plans because they experience information overload).

99. *Id.* (citation omitted).

100. *Id.* at 6 (citation omitted).

101. *Id.*

102. *Id.* at 6.

103. *Id.*

affected whether participants used the default option.¹⁰⁴ As expected, less knowledgeable individuals utilized the default option more often than more knowledgeable individuals did.¹⁰⁵ In one experiment, 20% of low-knowledge individuals used the default, compared to 2% of the high-knowledge individuals.¹⁰⁶ In a second experiment, 25% of low-knowledge individuals used the default, compared to 4% of the high-knowledge individuals.¹⁰⁷ This evidence suggests that many participants are not adept at properly directing the investment of their retirement accounts.¹⁰⁸

2. Potential Problems with the Investment Choices Offered

Retirement experts have also expressed concern with respect to the number of investment choices offered and the diversity of the options offered, as well as the types of funds offered to participants.

Zvi Bodie of the Pension Research Council found that there has been an increase in the last several years in the number of investment options offered to participants. Research has reflected an increase in the average number of funds offered from 16.7 in 2003 to 18.6 funds in 2004.¹⁰⁹ Larger plans had an even higher average number of funds of 28.7 in 2004.¹¹⁰ Bodie expressed the concern that “if people do not have the knowledge to make choices that are in their own best interests, increasing the number of choices may not necessarily make them better off. In fact, it could make them more vulnerable to exploitation by opportunistic salespeople or by well-intentioned, but unqualified, professionals.”¹¹¹

Research by Agnew and Szykman found that individuals with above-average financial knowledge experienced fewer feelings of information overload when there were fewer investment options. However, individuals with below-average financial knowledge continued to feel overload regardless of the number of investment options offered.¹¹²

Additionally, several professors of finance studied the adequacy and characteristics of the choices offered to 401(k) participants and found that many plans do not offer adequate investment options. Research indicates that 62% of 401(k) plans do not offer adequate investment choices to

104. *Id.* at 8–9.

105. *Id.*

106. *Id.* at 16–17.

107. *Id.* at 23.

108. *See id.* at 24 (“[T]he lack of financial knowledge in our sample raises concerns about the public’s ability to effectively manage their retirement accounts.”).

109. Nevin Adams, 2004 DC Survey, PLANSPONSOR.COM, Nov. 2004.

110. *Id.*

111. Bodie, *supra* note 80, at 9.

112. Agnew & Szykman, *supra* note 93, at 22.

participants.¹¹³ The research found that the plans offered an insufficient number and type of investment options that would enable a desirable portfolio to be created, or else offered poor-performing investment choices.¹¹⁴

There is also evidence that the manner in which investment options are presented affects the choices made.¹¹⁵ Data gathered by the Investment Company Institute (ICI) and Employee Benefit Research Institute (EBRI) reflecting 2003 year-end amounts indicated that the options participants were offered significantly affected how participants allocated their accounts.¹¹⁶ ICI and EBRI compared plans that included in their investment options guaranteed investment contracts and other stable value funds (collectively referred to as “GICs”) and/or company stock with plans that did not include these options. The study revealed that participants in plans that offered both GICs and company stock invested nearly 23% less in equity funds than plans that offered neither GICs nor company stock.¹¹⁷ Participants in plans that offered GICs but not company stock invested 7% less in equity funds than plans that offered neither GICs nor company stock.¹¹⁸ Thus, the study suggests that the options offered affected the investment allocations selected by participants.

These findings suggest that participants may be subject to a number of influences that adversely affect the manner in which they direct the investment of their retirement accounts. These influences range from unrealistic assessments of market risks and ignorance of market dynamics to the presentation of investment choices that are too narrow to meet diversification needs or too broad to permit effective analysis of the options.

113. Edwin J. Elton et al., *The Adequacy of Investment Choices Offered by 401(k) Plans* 1 (Dec. 2004), <http://pages.stern.nyu.edu/~mgruber> (follow “Research” hyperlink; then follow “The Adequacy of Investment Choices Offered by 401K Plans” hyperlink).

114. *Id.* at 2.

115. See Susan Stabile, *Freedom to Choose Unwisely: Congress’ Misguided Decision to Leave 401(K) Plan Participants to Their Own Devices*, 11 CORNELL J.L. & PUB. POL’Y 361, 381 (2002) (“By controlling which investment options are offered in a plan, how many options are offered, how the options are presented, and what types of disclosures about the choices are made, employers retain significant control over employee choices.”). See generally Jon D. Hanson & Douglas A. Kyser, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630 (1999); Mark Kelman et al., *Context-Dependence in Legal Decision Making*, 25 J. LEGAL. STUD. 287 (1996).

116. Sarah Holden & Jack VanDerhei, *Appendix: Additional Figures for the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project for Year-End 2003*, at 4 (Inv. Co. Inst., Washington, D.C.) (Aug. 2004), http://www.ici.org/pdf/per10-02_appendix.pdf.

117. *Id.* at 6 fig.A5.

118. *Id.*

B. Effectiveness of Potential Solutions

As a result of the concern over participants' ability to properly direct the investment of their retirement accounts, as well as participant demand, many employers have offered participants investment education, advice and life cycle funds. The effectiveness of these options has not been clearly evidenced.

1. Investment Education

Many employers have chosen to provide investment education to participants in their retirement plans. The DOL released guidance in 1996 that explained the types of investment information that could be provided to participants that would not be considered investment advice.¹¹⁹ These include plan information, general financial and investment information, asset allocation models, and interactive investment materials.¹²⁰

ERISA provides that persons who provide investment advice for a fee are fiduciaries.¹²¹ Prior to the release of guidance, some employers had been concerned that they would potentially have fiduciary liability for participants' investment decisions if they provided investment information, even if their plans complied with section 404(c) of ERISA.¹²² As a result of the DOL guidance, employers can provide investment education to participants without subjecting themselves to liability for losses resulting from participants' investment decisions, as long as the plans comply with section 404(c) of ERISA.

Investment education is now frequently offered by employers. A 2003 survey indicated that 89% of the employers surveyed offered investment education to employees.¹²³ A report by Lipper Research Services indicated that more than 83% of their survey respondents stated that they provided investment education to participants.¹²⁴

However, many employers have not been satisfied with their investment education programs. In a survey by ICC Plan Solutions, an investment education provider, only 11.9% of plan sponsors said they were

119. 29 C.F.R. § 2509.96-1 (1996).

120. *Id.*

121. 29 U.S.C. § 1002(21) (2000).

122. *Id.*

123. Press Release, Hewitt Assocs. LLC, U.S. Employers Remain Committed to 401(k) Plans Despite Weak Economy (Sept. 3, 2003), <http://was4.hewitt.com/hewitt/resource/newsroom/pressrel/2003/09-03-03.htm>. (Hewitt researched nearly five hundred large employers nationwide, which included more than three million employees.).

124. Fred Schneyer, *Lipper: Lifecycle Funds Explode in Popularity*, PLANSPONSOR.COM, Mar. 14, 2005, http://www.plansponsor.com/pi_type10/?RECORD_ID=28716 (citing Lipper Research Services, *Lifecycle Funds: Fit for Life*).

satisfied with their current programs.¹²⁵

2. Investment Advice

Some employers have elected to provide participants with investment advice as well as investment education. According to PLANSPONSOR's Eighth Annual Defined Contribution Services Survey (2004), 49% of the employers that responded offer investment advice to participants.¹²⁶ That reflects an increase from 43% of respondents in 2003 and 37% of respondents in 2002.¹²⁷ Similarly, the Deloitte Consulting 2004 Annual 401(k) Benchmarking Survey found that 40% of employers provided investment advice to some or all participants.¹²⁸ The survey found that approximately 14% of the participants in the respondents' plans used investment advice services and around 34% of those participants acted upon the recommendations.¹²⁹

The providing of investment advice corresponds with participant demand. According to a survey by CIGNA Retirement and Investment Services, 89% of 401(k) participants want "specific information on investment decision-making."¹³⁰ A 2004 survey by MetLife found that 43% of participants wanted the assistance of a financial planner for deciding how to invest their 401(k) accounts.¹³¹

125. Arnone, *supra* note 87, at 8.

126. Nevin Adams, *Advice Offerings Expand in 2004*, PLANSPONSOR.COM, Dec. 9, 2004, http://www.plansponsor.com/pi_type10/?RECORD_ID=27723 (according to PLANSPONSOR's Eighth Annual Defined Contribution Services Survey). *See also* Press Release, Soc'y for Human Res. Mgmt., Survey Finds Nearly Half of All Employers Offer Retirement Investment Advice (July 29, 2004), http://www.401khelpcenter.com/press_2004/pr_ebri_072904.html. (Employer-Sponsored Investment Advice Survey Report, sponsored jointly by the Society for Human Resources Management (SHRM), WorldatWork, and the Employee Benefit Research Institute (EBRI) found that "49 percent of respondents said their organizations offer some kind of investment advice to their defined contribution retirement plan participants.")

127. Adams, *Advice Offerings Expand in 2004*, *supra* note 126.

128. 2004 Annual 401(k) Benchmarking Survey (Deloitte Consulting LLP, Wilton, Conn.), Apr. 2005, at 24, available at http://www.deloitte.com/dtt/cda/doc/content/Annual_401k_Benchmarking_Survey_2004%281%29.pdf. *See also* Press Release, Ass'n for Fin. Prof'ls, Large U.S. Pension Funds Ease Restrictions on Company Stock and Offer More Advice for Participants (Jun. 26, 2003), http://www.afsonline.org/pub/pr/2003/pr03cie_ba_dcsrvy.html (indicating that "[m]ore than 40% of survey respondents indicated that they offer some type of investment advice to their DC plan participants.").

129. 2004 Annual 401(k) Benchmarking Survey, *supra* note 128, at 24.

130. Assistant Sec'y Ann L. Combs, Testimony Before the Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce (Feb. 13, 2003) (transcript available at <http://www.dol.gov/ebsa/newsroom/ty021303.html>).

131. THE METLIFE STUDY OF EMPLOYEE BENEFITS TRENDS: FINDINGS FROM THE 2004 NATIONAL SURVEY OF EMPLOYERS AND EMPLOYEES 2 (2004), available at <http://www.metlife.com/Applications/Corporate/WPS/CDA/PageGenerator/0,1674,P558,00>.

Under ERISA, a person who provides investment advice to a plan or its participants for a fee is a fiduciary.¹³² Section 404(c) of ERISA relieves a fiduciary of liability for losses that result from participants' exercise of independent control over their accounts.¹³³ The DOL has indicated that

[I]n the context of an ERISA section 404(c) plan . . . the designation of a fiduciary to provide investment advice to participants . . . would [not], in itself, give rise to fiduciary liability for loss, or with respect to any [fiduciary] breach . . . that is the direct and necessary result of a participant's . . . exercise of independent control.¹³⁴

However, employers who select other fiduciaries, such as investment advisors, are required to prudently select and monitor them. The DOL has stated that a fiduciary is required to prudently monitor an appointed fiduciary at reasonable intervals in "such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan."¹³⁵

In spite of the DOL's guidance, potential liability was identified by 35% of employers who participated in the Deloitte Consulting 2004 Annual 401(k) Benchmarking Survey as the primary reason that they did not provide investment advice to participants.¹³⁶ Other reasons identified were cost, by 24% of respondents, and lack of employee demand, by 16% of respondents.¹³⁷

A significant factor in the providing of investment advice is cost. If the goal of an investment advisor is to increase participants' rates of return on their investments, any increased return should be netted against the cost to the participant for the advisor. The Employer-Sponsored Investment Advice Survey Report found that 53% of the respondents indicated that investment advice is provided to participants free of charge.¹³⁸ Twenty-three percent of respondents indicated that the employer paid for it, while

html (follow "2004 MetLife Study of Employee Benefits Trends" hyperlink).

132. 29 U.S.C. § 3(21) (2002).

133. See 29 U.S.C. § 404(c); 29 C.F.R. § 2550.404c-1(c)(1) (1997) (stating that regulations on an employer's relief from fiduciary obligations apply only with respect to transactions where a participant exercised independent control over the participant's individual account).

134. 29 C.F.R. § 2509.96-1 (1996).

135. 29 C.F.R. § 2509.75-8 (1975).

136. 2004 Annual 401(k) Benchmarking Survey, *supra* note 128, at 25.

137. *Id.*

138. Survey Finds Nearly Half of All Employers Offer Retirement Investment Advice, *supra* note 126 (reporting on Employer-Sponsored Investment Advice Survey Report, sponsored jointly by the Society for Human Resources Management (SHRM), WorldatWork, and the Employee Benefit Research Institute (EBRI)).

8% stated that participants paid for it.¹³⁹

The limited data analyzing the effectiveness of investment advice reflected a modest change in asset allocations after advice was provided. A study by Ernst & Young LLP and ExecuNet found that plans that provided financial counseling reflected an increase of up to 11% in the change in allocations in excess of 5% of the participant's account.¹⁴⁰ Similarly, a 2002 survey by the International Society of Certified Employee Benefit Specialists found that 18% of participants changed their asset allocations after using online advice services.¹⁴¹ However, 70% of employers were not aware of the impact of the investment advice.¹⁴²

PLANSPONSOR's Eighth Annual Defined Contribution Services Survey (2004) indicated that "[d]espite the expanding availability of financial guidance, participants were still inclined to over-invest in company stock, by most standard measures."¹⁴³

Based on the available information, it is not clear that investment advice is an effective means of increasing participants' rates of return.

3. Life Cycle Funds

Employers are also utilizing life cycle funds to assist participants with directing the investment of their accounts. Life cycle funds provide participants with the ability to select an investment that is designed to achieve specific investment objectives. Some life cycle funds focus on levels of risk tolerance, offering conservative, moderate and aggressive portfolios. Others focus on target retirement dates. These typically provide for greater risk the longer the time frame before the target retirement date, becoming more conservative as that date approaches. Conceptually, life cycle funds are intended to manage the allocation of a participant's entire account balance for them.

Life cycle funds are increasing in popularity among employers. A report from Lipper Research Services indicated that there were more than 244 life cycle funds at the end of 2004.¹⁴⁴ These funds held approximately \$139 billion in assets. This reflected an increase of 38% from the end of 2003, when there were 205 funds with \$101 billion in assets.¹⁴⁵ Fidelity Investments found that life cycle funds "were the most rapidly adopted

139. *Id.*

140. Press Release, Ernst & Young LLP, Financial Counseling Critical Component of Retirement Planning; Education Not Sufficient (Nov. 18, 2004), http://www.401khelpcenter.com/press_2004/pr_ey_111804.html.

141. AMERIKS ET AL., *supra* note 81, at 10–11.

142. *Id.*

143. Adams, *supra* note 126.

144. Schneyer, *supra* note 124.

145. *Id.*

automatic plan feature during 2004, with approximately 1,200 employers going in that direction.”¹⁴⁶ Fidelity’s analysis revealed that 75% of the plans that used Fidelity offered at least one life cycle fund, and 6% of plans selected a life cycle fund as their default investment option.¹⁴⁷

However, the Compass Institute has asserted that life cycle funds will not generate sufficient returns net of expenses to justify their use.¹⁴⁸ The Compass Institute’s survey found that most companies’ existing plans could yield an eleven percent rate of return with extremely low risk, while life cycle funds are unlikely to be able to reach that rate of return with comparable risk.¹⁴⁹

Thus, life cycle funds provide the advantage of having a professional manage the accounts of participants who do not want to actively direct their investments. However, it is unclear whether the costs for these services outweigh the benefits.

C. Rates of Return for Participant-Directed Accounts

There are conflicting studies on the effects of participants’ investment choices.

Studies have shown that participants who direct their accounts have lower investment returns than institutional investors. One study reflected that investment returns by defined contribution plan participants were two percent lower per year than the returns achieved by institutional investors.¹⁵⁰ This could result in a difference in retirement savings of nearly three-quarters of a million dollars.¹⁵¹

A study comparing defined benefit plans and 401(k) plans reflected that the performance of 401(k) plans compared to defined benefit plans has varied depending on the time frame considered. The study examined the Form 5500, Annual Return/Report for Employee Benefit Plan filings for companies that sponsored one defined benefit plan and one 401(k) plan.¹⁵²

146. Fred Schneyer, *Fidelity: Life Cycle Funds, Automatic Plan Programs Gaining Popularity*, PLANSPONSOR.COM, Jan. 13, 2005, http://www.plansponsor.com/pi_type10/?RECORD_ID=28105 (analyzing 12,806 employer-sponsored retirement plans Fidelity administers, representing nearly eleven million participants).

147. *Id.*

148. Fred Schneyer, *Study: Plans Need 11% Average Annual Return*, PLANSPONSOR.COM, Sept. 20, 2004, available at http://www.plansponsor.com/pi_type10/?RECORD_ID=26766.

149. *Id.*

150. Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 88 (2002) (citing Barclays Global Investors, *Mind the Gap! Why DC Plans Underperform DB Plans, and How to Fix Them*, INVESTMENT INSIGHTS, Apr. 2000, at 1).

151. *Id.* n.70.

152. *Defined Benefit vs. 401(k) Returns: The Surprising Results*, INSIDER, Jan. 2002,

The study was structured in this manner in order to eliminate any effects of company or employee characteristics.¹⁵³ The difference between the median returns for each type of plan varied from year to year.¹⁵⁴ For example, from 2000 to 2002, defined benefit plans significantly outperformed 401(k) plans.¹⁵⁵ In 2000, 401(k) plans lost an average of 4.28%, while defined benefit plans had relatively no gain or loss.¹⁵⁶ In 2001, 401(k) plans lost an average of 7.30%, while defined benefit plans only lost an average of 3.82%.¹⁵⁷ Again in 2002, 401(k) plans did worse than defined benefit plans, losing 12.26% compared to 8.43%, respectively.¹⁵⁸ However, an average of the median returns from 1990 through 1998 reflect that defined benefit plans' returns were only 0.7% higher than the returns for 401(k) plans.¹⁵⁹ One of the reasons for the slightly higher returns for the defined benefit plans may be that the participants in the 401(k) plans selected investments with greater risk since they had a guaranteed benefit in the defined benefit plan.

The study examining the Form 5500 filings appears to indicate that participants, on average, approximated the returns received by defined benefit plans, which typically hire professional investment managers. These results imply that average participants are able to invest over long periods of time nearly as well as professional investment managers. Alternatively, the returns could be attributable to the professional investment managers who manage the mutual funds in which many 401(k) plans invest. Additional research should consider other types of participants.

IV. EFFECT ON EMPLOYERS

Employers typically provide retirement benefits in order to obtain and retain employees. Companies must consider the cost of providing benefits with investment flexibility in achieving business objectives. To reduce employer liability for investment risk while satisfying employee demand

available at <http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=9378&Component=The+Insider> (analyzing Form 5500 filing from 1995 through 1998 and recalculating 1990 through 1995 by using previously unavailable data).

153. *Id.*

154. *Id.*

155. Kip McDaniel, *DB Plans Outperformed 401(k)s in 2000–2002 Bear Market*, PLANSPONSOR.COM, Nov. 22, 2004, available at http://www.plansponsor.com/pi_type10/?RECORD_ID=27559 ("The data provided by Watson Wyatt . . . is based on the Form 5500 filings of over 2,000 publicly traded domestic companies. Companies that sponsored more than one DB and/or 401(k) plan were excluded from the survey.").

156. *Id.*

157. *Id.*

158. *Id.*

159. *Defined Benefit vs. 401(k) Returns: The Surprising Results*, *supra* note 152.

for investment flexibility, many employers allow participants to direct the investment of their retirement plan accounts.

However, some employers may improperly evaluate the protection afforded by ERISA section 404(c). As a result, employers may fail to properly weigh the benefits of allowing participants to direct the investment of their accounts against the potential risks. This is particularly significant in light of experts' concerns regarding participants' ability to effectively direct the investment of their accounts. In evaluating the level of protection afforded by ERISA section 404(c), some employers may not be: (i) considering the areas in which 404(c) protection is not available; (ii) assessing their level of compliance with 404(c); (iii) understanding the risks if their plans do not comply with 404(c); and (iv) factoring in the potential litigation costs as a result of allowing participants to direct the investment of their accounts.

Companies and their boards of directors and officers are often the fiduciaries of the companies' retirement plans. Frequently, companies are designated as named fiduciaries for their retirement plans. Their boards of directors often designate persons, such as the company's officers, to manage the retirement plans. Under these circumstances, the board and the persons selected by the board are fiduciaries.¹⁶⁰ As a result, potential liability associated with allowing participants to direct the investment of their accounts may affect companies as well as their boards of directors and certain executives.

A. Fiduciaries' Responsibilities Not Covered by ERISA Section 404(c)

Fiduciaries' duties are described in ERISA section 404(a). They include the requirement that fiduciaries discharge their duties regarding the plan solely in the interest of participants and for the exclusive purpose of providing benefits to participants and paying reasonable administrative expenses. Fiduciaries must also use the "care, skill, prudence and

160. 29 U.S.C. § 1002(21) (2002). The positions held by members of a company's board of directors and officers do not automatically cause them to become fiduciaries. As the DOL explains in Interpretive Bulletin 75-8:

[M]embers of the board of directors of an employer which maintains an employee benefit plan will be fiduciaries only to the extent that they have responsibility for the functions described in section 3(21)(A) of the Act. For example, the board of directors may be responsible for the selection and retention of plan fiduciaries. In such a case, members of the board of directors exercise "discretionary authority or discretionary control respecting management of such plan" and are, therefore, fiduciaries with respect to the plan.

29 C.F.R. § 2509.75-8, D-4 (1975).

diligence”¹⁶¹ that a prudent person would use and diversify the plan’s investments. Furthermore, fiduciaries must act in accordance with the plan’s documents, unless they conflict with ERISA.

ERISA section 404(c) only provides that fiduciaries will not be liable for losses that result from the participants’ allocation of their accounts among the investment options offered by the plan. As a result, all of the fiduciaries’ duties, other than investing the plan assets handled by participants, continue to apply. Some fiduciaries misunderstand the manner in which ERISA section 404(c) operates and fail to recognize that they continue to be responsible for prudently selecting and monitoring the investment options offered to participants and for investing the accounts of participants who do not affirmatively direct the investment of their accounts.

1. Fiduciaries Remain Responsible for Prudently Selecting and Monitoring Investments

Plan fiduciaries are responsible for prudently selecting and monitoring their plan’s investments.¹⁶² ERISA section 404(c) provides that fiduciaries will be relieved of liability for losses that result from a participant’s exercise of control over the participant’s account. In the preamble to the 404(c) regulations, the DOL explains:

[T]he act of limiting or designating investment options which are intended to constitute all or part of the investment universe of an ERISA 404(c) plan is a fiduciary function [T]he plan fiduciary has a fiduciary obligation to prudently select such vehicles, as well as a residual fiduciary obligation to periodically evaluate the performance of such vehicles to determine, based on that evaluation, whether the vehicles should continue to be available as participant investment options.¹⁶³

Additional DOL guidance reflects this position. In Advisory Opinion No. 98-04(A), the DOL stated: “the act of designating investment alternatives in an ERISA section 404(c) plan is a fiduciary function to which the limitation on liability provided by section 404(c) is not applicable.”¹⁶⁴ Similarly, in an information letter, the DOL indicated, “The responsible plan fiduciaries are also subject to ERISA’s general fiduciary standards in initially choosing or continuing to designate investment

161. 29 C.F.R. § 2550.404a-1 (1979).

162. 29 U.S.C. § 1104.

163. 57 Fed. Reg. 46,906, 46,924 n.27 (Oct. 13, 1992).

164. U.S. Dep’t Of Labor PWBA Advisory Opinion 98-04A n.1 (May 28, 1998), available at <http://www.dol.gov/ebsa/programs/ori/advisory98/98-04a.htm> (citation omitted).

alternatives offered by a 404(c) plan.”¹⁶⁵

The court in *In re Unisys Savings Plan Litigation*¹⁶⁶ (“*Unisys I*”) took a position that conflicted with the DOL’s position. *Unisys I* involved transactions that occurred prior to the issuance of the DOL’s final regulations. The court in *Unisys I* held that fiduciaries who breached their duties regarding the investments offered by the plan could escape liability if they could prove that the participants’ losses were caused by their exercise of control. The court stated:

There is nothing in section 1104(c) which suggests that a breach on the part of a fiduciary bars it from asserting section 1104(c)’s application. On the contrary, the statute’s unqualified instruction that a fiduciary is excused from liability for “any loss” which “results from [a] participant’s or [a] beneficiary’s exercise of control” clearly indicates that a fiduciary may call upon section 1104(c)’s protection where a causal nexus between a participant’s or a beneficiary’s exercise of control and the claimed loss is demonstrated. This requisite causal connection is, in our view, established with proof that a participant’s or a beneficiary’s control was a cause-in-fact, as well as a substantial contributing factor in bringing about the loss incurred.¹⁶⁷

However, several courts since then have agreed with the DOL’s position. The court in *Franklin v. First Union Corp.*¹⁶⁸ held that plan fiduciaries are responsible for selecting and removing their plans’ investment options when the plans comply with ERISA section 404(c). Similarly, the Court in *In re Sprint Corporation ERISA Litigation*¹⁶⁹ indicated that “the act of designating investment alternatives is a fiduciary function regardless of a plan’s purported § 404(c) status.”¹⁷⁰ The court in *In re Enron Corp. Securities, Derivative & ERISA Litig.*¹⁷¹ explained that “[l]osses that do not ‘result from’ the participant’s exercise of control are still charged against the plan fiduciary, which retains the duty to prudently select investment options under the plan and to oversee their performance on a continuing basis.”¹⁷²

Thus, fiduciaries are required to prudently select and monitor their plans’ investments, even if the plans comply with ERISA section 404(c). In order to satisfy their fiduciary duties, they should engage in a prudent

165. DOL Information Letter, 1997 WL 1824017, at *2 (Nov. 26, 1997).

166. 74 F.3d 420 (3d Cir.), cert. denied, 519 U.S. 810 (1996).

167. *Id.* at 445 (footnote omitted).

168. 84 F. Supp. 2d 720, 732 (E.D. Va. 2000).

169. 2004 U.S. Dist. LEXIS 9622, at *6, dismissed by, in part, 2004 U.S. Dist. LEXIS 19125 (D. Kan., Sept. 24, 2004).

170. *Id.*

171. 284 F. Supp. 2d 511, 578 (S.D. Tex. 2003).

172. *Id.*

process to regularly review the investments offered by the plan, determine if each investment is suitable for the plan and its participants, and remove any investment choices that do not satisfy their requirements.

2. Responsibility for Non-Participant Directed Accounts

Some employers are not aware that fiduciaries are responsible for allocating plan assets among the selected investment choices unless participants direct the investment of their accounts.¹⁷³ The Preamble to the ERISA section 404(c) regulation states, “[U]ntil a participant or beneficiary exercises control with respect to assets contributed on his behalf, plan fiduciaries are subject to all of the fiduciary duties and obligations set forth in . . . ERISA with respect to such assets.”¹⁷⁴ The Preamble explains that fiduciaries of 404(c) plans “have a duty to provide for the investment of idle plan assets, and lack of participant direction will not absolve a fiduciary from such duties.”¹⁷⁵

Many fiduciaries select one investment option in which they invest all non-directed accounts, referred to as a default account. However, the use of a default account does not relieve fiduciaries of the responsibility for prudently investing those plan assets. The Preamble indicates, “[P]lan provisions providing for investments in the absence of an affirmative exercise of control may be followed only if the fiduciary determinations [sic] that following such provisions would not violate his fiduciary duties, including his duties under sections 404 and 406 of ERISA.”¹⁷⁶

Surveys have indicated that most fiduciaries select a short-term investment option as a default account. The Deloitte Consulting 2004 Annual 401(k) Benchmarking Survey reflected that 58% of plans had a short-term fund, such as stable value or money market funds, as their default investment election for respondents with automatic enrollment.¹⁷⁷ The 45th Annual Survey of Profit Sharing/401(k) Council of America (PSCA) indicated that nearly 48% of the surveyed plans selected either the stable value or money market funds as their default option for automatic enrollment plans.¹⁷⁸

173. 29 U.S.C. § 1104(a) (2002).

174. 57 Fed. Reg. 46,906, 46,907 (Oct. 13, 1992).

175. *Id.* at 46,923.

176. *Id.*

177. *Deloitte Consulting 2004 Annual 401(k) Benchmarking Survey*, *supra* note 128, at 7. See also Large U.S. Pension Funds Ease Restrictions on Company Stock and Offer More Advice for Participants, CIEBA Defined Contribution Survey (Jun. 26, 2003) (“[M]ore than 40% of survey respondents indicated that they offer some type of investment advice to their DC plan participants.”).

178. 45th Annual Survey (Profit Sharing/401(k) Council of America, Chicago, IL) (2002) (reflecting 2001 plan year data).

The DOL Regulations to ERISA section 404(a) provide that fiduciaries should consider the investments' anticipated return in light of the funding objectives.¹⁷⁹ Arguably, short-term investments are not consistent with long-term funding objectives, such as the goals for investing for retirement purposes. Agnew and Szykman indicated that they did not consider the default investment to be appropriate for many participants.¹⁸⁰ They found that these investments are usually very conservative, not tailored to the participant's needs and frequently result in insufficient retirement benefits for the participant.¹⁸¹

Thus, fiduciaries are required to invest the accounts of participants who do not direct the investment of their accounts in a manner that is suitable for retirement investing. Based on the available research, it does not appear as though conservative, short-term investments would satisfy this requirement.

B. Assessing Compliance with ERISA Section 404(c)

In evaluating the benefits and risks of allowing participants to direct their investments, many employers mistakenly assume that their plans comply with ERISA section 404(c).¹⁸² Additionally, there are ambiguities in the regulation to section 404(c) that could result in plans' non-compliance. If a plan does not comply with ERISA section 404(c), fiduciaries would not be able to rely on its protection to relieve them from losses attributable to participants' investment directions.

1. Non-compliance with Regulation

Several practitioners have identified common areas of non-compliance with ERISA section 404(c). These include the failure to provide participants with: (i) the identity and contact information of the 404(c) fiduciary; (ii) prospectuses immediately before or after participants' initial investments in particular options; (iii) a notice that the plan intends to comply with section 404(c); and (iv) a description of the additional information the participants may request.¹⁸³

179. 29 C.F.R. § 2550.404a-1 (1979).

180. Agnew & Szykman, *supra* note 93, at 3.

181. *Id.*

182. See *Deloitte Consulting 2004 Annual 401(k) Benchmarking Survey*, *supra* note 128, at 21 (indicating in Exhibit 89 that 93% of respondents notified participants that their plans intended to comply with ERISA section 404(c)).

183. Fred Reish & Joe Faucher, *Enron, 404(c) and the Personal Liability of Corporate Officers*, JOURNAL OF PENSION BENEFITS, Winter 2003, at 102; Kathleen Sheil Scheidt & David L. Wolfe, *Prudence and Diversification Revisited—ERISA Section 404(c) Protection in the Wake of Enron*, EMPLOYEE BENEFITS JOURNAL, March 2003, at 23, 28.

In one of the few cases that involved ERISA section 404(c) and transactions that took place after the issuance of the final regulations to ERISA section 404(c), the court found that the employer had failed to provide sufficient evidence that it had satisfied the requirements of the section. In *In re Enron Corp. Securities, Derivative & ERISA Litigation*, the court noted that Enron had not demonstrated that it had provided participants with an explanation that the plan intended to satisfy 404(c) or notification that if the plan satisfied ERISA section 404(c), the fiduciaries would be relieved of liability.¹⁸⁴

As a result, some employers may improperly be relying on the protection afforded them under section 404(c) when their plans do not strictly comply with 404(c) requirements. This reliance may subject employers to unanticipated liability.

2. Ambiguities in ERISA Section 404(c)

Although the regulation affecting ERISA section 404(c) provides considerable details regarding its requirements, the section remains somewhat ambiguous. It is possible that a court could interpret its provisions differently than fiduciaries. Examples of potential ambiguities include the types of information to be provided to participants and prospectus delivery requirements.

The regulation indicates that ERISA section 404(c) protection is only available if a “participant or beneficiary is provided or has the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan, and incidents of ownership appurtenant to such investments.”¹⁸⁵ The regulation identifies requirements that must be satisfied in order to comply with this provision; however, it also implies that the detailed requirements do not represent all of the information that must be provided. Thus, plan fiduciaries do not have definitive guidelines to follow in order to ensure they satisfy this provision of the regulation.

Additionally, the regulation provides that ERISA section 404(c) protection is only available if “[i]n the case of an investment alternative which is subject to the Securities Act of 1933, and in which the participant or beneficiary has no assets invested, immediately [preceding or] following the participant’s or beneficiary’s initial investment, a copy of the most recent prospectus provided to the plan”¹⁸⁶ is provided to the participant or beneficiary. The regulation is unclear as to what time frame “immediately”

184. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 284 F. Supp. 2d 511, 575 (S.D. Tex. 2003).

185. 29 C.F.R. § 2550.404c-1(b)(2)(B) (1993).

186. 29 C.F.R. § 2550.404c-1(b)(2)(B)(i)(viii) (1993).

refers to. As a result, plans may be deemed to have failed to deliver prospectuses in accordance with the regulation, when, in fact, they have not failed.

While some may find these issues to be mere subtleties of the law, it is possible that under certain circumstances, a plan that considers itself to satisfy ERISA section 404(c) will not.

C. Fiduciary Responsibility for Participants' Investment Choices When ERISA Section 404(c) Is Not Available

ERISA section 404(c) provides that fiduciaries are relieved of liability from losses resulting from participants' direction of the investment of their accounts. Fiduciaries are not, however, relieved of liability if their plans do not comply with section 404(c). This does not necessarily mean that the fiduciaries would be liable for losses resulting from participants' investment directions.

ERISA section 404(c) provides that participants shall not be deemed fiduciaries as a result of directing the investment of their accounts. As a result, participants who direct the investment of their accounts could arguably be fiduciaries if the plan does not comply with section 404(c), as a person who exercises discretionary control over a plan's assets is a fiduciary of that plan.¹⁸⁷ As fiduciaries, they could potentially be responsible for prudently investing their accounts.¹⁸⁸ This seems fairly unlikely, as it would seem to obviate the need for ERISA section 404(c).

Fiduciaries are liable for breaches of fiduciary duties by a co-fiduciary under certain circumstances.¹⁸⁹ A fiduciary may be liable if the fiduciary: (i) knowingly participates in or conceals the act or omission of another fiduciary; (ii) enables another fiduciary to commit a breach as a result of his failure to comply with the fiduciary duties; or (iii) knows about the co-fiduciary's breach and fails to make reasonable efforts to remedy it.¹⁹⁰ As a result, even if participants were considered fiduciaries, the named fiduciaries would also be liable as co-fiduciaries.¹⁹¹

187. 29 U.S.C. § 1002(21) (2002).

188. 29 U.S.C. § 1104(a). They would not be responsible for the investment of any other participants' account or the plan itself, as their fiduciary responsibility is limited to the extent they have responsibility for the actions described in 29 U.S.C. § 1002(21)(A). 29 C.F.R. § 2509.75-8, D-4 (1993).

189. See 29 U.S.C. § 1105(a) (listing "[c]ircumstances giving rise to liability").

190. *Id.*

191. See 29 C.F.R. § 2509.75-8, FR-14 (indicating circumstances in which named fiduciaries would be liable as co-fiduciaries). See generally *Varity Corp. v. Howe*, 516 U.S. 489 (1996); *Curtiss Wright Corp. v. Schoonejongen*, 514 U.S. 73 (1995); *Lockheed Corp. v. Spink*, 517 U.S. 882 (1996). However, at a meeting between the American Bar Association and the DOL, the representatives from the DOL stated, "A plan cannot side-step the

D. *Litigation Expenses*

Although ERISA section 404(c) may relieve fiduciaries of liability for losses resulting from participants' direction of the investment of their accounts, they may incur considerable expenses to defend themselves in such litigation. Since ERISA section 404(c) is based on the actions required to be taken by the plan and its fiduciaries, discovery in these cases can be substantial. The court in *In re AEP ERISA Litigation* explained: "The determination of whether an ERISA plan is an individual account plan is fact-intensive."¹⁹² The court indicated that courts need to examine whether participants were given sufficient information about the risks and consequences of the investment options, their rights and the fiduciaries' obligations, as well as the ability to change their investment allocations.

As a result, motions to dismiss are frequently not granted. The court in *In re AEP ERISA Litigation* indicated "courts routinely refuse to dismiss an ERISA action because the defendant argues section 404(c) applies."¹⁹³ A similar position was taken in *Rankin v. Rots*,¹⁹⁴ which stated, "Whether or not section 404(c) applies is not a question on a motion to dismiss. Section 404(c) provides defendants with a defense to liability; it does not mean that [the plaintiff] has failed to make out a claim against them."

In litigation involving ERISA section 404(c), the fiduciaries have the burden of proving they can rely on the protection afforded by 404(c). The court in *In re Enron Corp. Securities, Derivative & ERISA Litigation* explained, "Because § 404(c) in essence exempts a fiduciary from liability that he normally would have under 29 U.S.C. § 1109(a), the fiduciary seeking protection under § 404(c), and not the plaintiff, has the burden of demonstrating that it applies."¹⁹⁵

requirements of section 404(c) by taking the position that a participant who exercises investment discretion over his or her accounts is a plan 'fiduciary.'" Fred Reish and Joe Faucher, *ERISA Section 404(c)—How Does It Really Work, and What Does It Matter?*, JOURNAL OF PENSION BENEFITS, Autumn 2002, at 55.

192. *In re AEP ERISA Litigation*, 327 F. Supp. 2d 812, 815 (S.D. Ohio 2004). See also *In re Enron Corp. Sec. Derivative ERISA Litig.*, 284 F. Supp. 2d 511, 578–79 (noting the kinds of evidence that must be produced in evaluating whether or not a plan qualified as a 404(c) plan).

193. *In re AEP ERISA Litigation*, 327 F. Supp. 2d 812, 829 (S.D. Ohio 2004).

194. *Rankin v. Rots*, 278 F. Supp. 2d 853, 872 (E.D. Mich. 2003). See also *Vivien v. Worldcom Inc.*, No. C 02-01329 WHA, 2002 WL 31640557 at *6 (N.D. Cal. July 26, 2002) (stating that a statutory bar to liability does not warrant a motion to dismiss at early stages of litigation).

195. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 284 F. Supp. 2d at 578.

E. Conclusion

The consequences to employers of allowing participants to direct the investment of their accounts is unclear. There is the potential for significant liability to employers if participants do not properly invest their accounts. Given the uncertainty surrounding ERISA section 404(c), employers may be placing too much reliance on the potential protection of ERISA section 404(c).

V. SUGGESTIONS FOR MAKING THE SYSTEM WORK BETTER

A. Disclosure to Workers and Guidance to Fiduciaries

Under the current system, workers do not have to be notified that they are not required to direct the investment of their defined contribution plan accounts. In fact, many forms for electing deferrals request that participants indicate the manner in which they want their accounts invested. It is unclear to what extent workers would be notified that they are not required to direct the investment of personal accounts under the proposed changes to the Social Security system.

Additionally, fiduciaries are given fairly vague guidance about the manner in which retirement plans should be invested. ERISA's prudence requirements set forth general principles regarding the investment of plan assets, but do not provide specific guidance regarding the manner in which a fiduciary should do so.

Notifying workers that they may elect to make deferrals without selecting the investment of their accounts for both retirement plans and Social Security personal accounts may be beneficial for workers and society. As a result of notification, fewer workers who were not willing to understand the principles of investing would direct the investment of their accounts.

Guidance regarding notification requirements could be combined with a safe harbor for fiduciaries that they can use to invest the accounts of participants who do not want to allocate the investment of their plan assets. In this way, plans could provide for a reasonable rate of return for retirement purposes without, or with a reduced, fear of litigation from participants and the Department of Labor.

B. Analyzing the Effect of Individual Direction of Investments and the Effectiveness of Tools to Assist Workers

The available studies do not clearly indicate whether participants receive lower long-term rates of return than professional investors. The ability to invest in mutual funds may account for this problem. As a result, additional research should be done to determine whether the effect of long-term retirement investing by individuals results in lower retirement savings.

Furthermore, the effects of the tools available to assist individuals with investing on investment returns are not clear. It is not clear whether tools such as investment education, investment advice and life cycle funds are effective for increasing the rate of return. In order to determine whether these tools should be encouraged or even required, additional research must be done to determine the extent to which participants' rates of return increase with their use.

C. Provide an ERISA Section 404(c) Safe Harbor to Reduce Litigation Costs

ERISA section 404(c) is currently of limited value to employers. Even if fiduciaries believe they are complying with all of ERISA section 404(c)'s requirements, they may still be subject to significant litigation expenses defending an allegation that the plan did not comply. Additionally, a court may find that they did not comply as a result of the ambiguities in the regulations.

These issues could be significantly reduced if the DOL issued a safe harbor for plans that allow participant direction of the investments of their accounts. The ERISA section 404(c) regulation could be revised to provide for a safe harbor that, if met, would enable the fiduciary for the plan to automatically satisfy ERISA section 404(c). The safe harbor could be based on the principles of the current regulation and would apply if participants were only allowed to invest in diversified investment vehicles such as mutual funds. Investment choices could be limited to a moderate number of funds that provide for basic diversification with limited risk. The disclosure requirements could be deemed satisfied if certain notices were handled in a manner consistent with the distribution of other required disclosures, such as summary plan descriptions, and under certain circumstances, blackout period notices and notices pursuant to ERISA section 204(h). The safe harbor could only be effective with respect to those participants who affirmatively made investment choices. Additionally, the safe harbor could only be effective to the extent the plan fiduciary prudently selected and monitored the investment performance of the funds being offered. Fiduciaries could demonstrate compliance with

this requirement by providing evidence of meetings discussing the plan's investments, such as committee minutes. Additionally, fiduciaries would need to provide documentation that reflected that the investments offered by the plan were independently rated to be in the middle or upper rankings of the investments in their class.

The use of a safe harbor would allow the benefits of ERISA section 404(c) to be maintained, while more effectively providing the protection intended by ERISA section 404(c) for fiduciaries.

D. Conclusion

Participant-direction of retirement savings has been utilized for many years. Additionally, many advocate allowing workers to self-direct a portion of their retirement savings. However, we currently lack sufficient information to determine how best to provide choices to workers without unnecessarily increasing the risk that adequate retirement assets will not be available to them. Given the inconsistencies in the studies that have been performed, additional studies should be conducted to determine whether workers, on average, are effective at directing the investment of their accounts. The potential consequences are significant, given the amount of the tax subsidy for retirement plans and the risks to the Social Security system.